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# Recent Tax Developments in the Taxation of Corporations and Shareholders

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## CHAPTER 2

# RECENT DEVELOPMENTS IN THE TAXATION OF CORPORATIONS AND SHAREHOLDERS

Professor Daniel J. Lathrope

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## CHAPTER 2

# RECENT DEVELOPMENTS IN THE TAXATION OF CORPORATIONS AND SHAREHOLDERS

### 2.1.0 Introduction

This chapter generally covers income tax developments involving C corporations and their shareholders that occurred between October 1, 1996, and September 15, 1997 (the date that research for this outline was completed). However, this outline generally does not cover developments involving international tax, specialized industries (e.g., insurance companies, financial institutions, farming, and natural resources), pension plan and other deferred compensation topics, procedural issues, or the excise tax and employment tax provisions of the Code. This outline also generally does not cover developments involving consolidated returns, S corporations and their shareholders, the "check-the-box" regulations and entity classification issues, or limited liability companies, since there are separate presentations on each of those topics at this year's Institute.

### 2.2.0 Taxpayer Relief Act of 1997

#### 2.2.1 Introduction

On August 5, 1997, President Clinton signed into law the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 [hereinafter the "Act"]. The Act made a number of changes affecting C corporations and their shareholders.

#### 2.2.2 Reduction in Maximum Rate on Net Capital Gains of Individuals

##### .1 Introduction

The Act generally reduces the maximum tax rate on the net capital gain of an individual from 28 percent to 20 percent. IRC §1(h). Net capital gain of a taxpayer taxed at the 15-percent rate is taxed at a 10 percent rate. The lower capital gains rates apply to the sale or exchange of assets held for more than 18 months. The maximum tax rate on net capital gain attributable to any long-term capital gain from the sale or exchange of collectibles, qualified small business stock, and mid-term gain (assets held more than one year but not more than 18 months) is 28 percent. The maximum tax rate on unrecaptured IRC §1250 gain (all depreciation on depreciable real property held for more than 18 months) is 25 percent. The Act's new rates apply for purposes of both the regular tax and the alternative minimum tax. In addition, for taxable years beginning after December 31, 2000, the maximum capital gains rates for assets which are acquired after that date and held more than five years, are 8 percent and 18 percent, instead of 10 percent and 20 percent.

##### .2 Implications for Subchapter C

The reduction in the maximum tax rate on long-term capital gains from sales or exchanges of stock increases the maximum tax rate difference between dividends and capital gains to 19.6 percent (36.9 percent versus 20 percent). Thus, the provisions in

Subchapter C that distinguish dividends or ordinary income from capital gains (e.g., IRC §§302, 304 and 306) take on increased importance.

### **2.2.3 Changes in Treatment of Qualified Small Business Stock**

#### **.1 Introduction**

New IRC §1045(a) allows an individual shareholder to elect to roll over tax-free gain from the sale or exchange of qualified small business stock (as defined in IRC §1202(c)) held more than six months where the shareholder uses the proceeds to purchase other qualified small business stock within 60 days of the sale. Gain is recognized only to the extent that the amount realized on the sale exceeds the amount reinvested in qualified small business stock during the 60-day period. IRC §1045(a) applies to sales made after enactment of the Act.

#### **.2 Basis and Holding Period**

The basis of the purchased stock is its cost reduced by the amount of gain that was not recognized. IRC §1045(b)(3). For purposes of the rollover provision, the replacement stock must meet the active business requirement in IRC §1202(c)(2) for the six-month period following the purchase. IRC §1045(a)(4)(B). The holding period of the purchased stock will include the holding period of the stock sold, except for purposes of determining whether the holding period for the rollover provision is met. IRC §1045(a)(4)(A).

#### **.3 Change in AMT Preference**

The Act also reduces the AMT preference from the sale of qualified small business stock to 42 percent (down from 50 percent) of the amount excluded from gross income under IRC §1202. IRC §57(a)(7).

### **2.2.4 Required Gain Recognition for Certain Extraordinary Dividends**

Under the Act, a corporate shareholder now recognizes gain immediately when the untaxed portion of an extraordinary dividend exceeds the basis of the stock with respect to which the dividend was received. IRC §1059(a)(2). Previously, if the reduction in basis exceeded the stock's basis, the excess was taxed at the sale or disposition of the stock, but not before that time. The prior provision had been used by corporate taxpayers to structure redemptions taxed as dividends, claim a dividends-received deduction, and defer gain recognition. The Act also changes the definition of an extraordinary dividend to include any redemption which is treated as a dividend due to options being counted as stock ownership. IRC §1059(e)(1)(A)(iii)(I). An exchange described in IRC §356 which is treated as a dividend is also now treated as a redemption for purposes of applying the IRC §1059 rules relating to redemptions. IRC §1059(e)(1)(B).

### **2.2.5 Required Gain Recognition on Certain Distributions of Controlled Corporation Stock (IRC Section 355 and *Morris Trust* Transactions)**

#### **.1 Introduction**

Under new IRC §355(e), a distributing corporation generally must recognize gain on a spin-off otherwise qualifying under IRC §355 if either the distributing corporation or a controlled corporation is acquired pursuant to a plan (or series of related transactions) in existence on the date of the distribution. IRC §§355(e)(1), 355(e)(2)(A). The amount of gain recognized is the amount that the distributing corporation would have recognized if it had sold the stock of the controlled corporation for its fair market value on the date of the distribution. The distributing corporation or a controlled corporation is considered

acquired if one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest (by vote or value) in the corporation. IRC §§355(e)(2)(A)(ii), 355(e)(4)(A). Aggregation and modified attribution rules apply to determine stock ownership. IRC §355(e)(4)(C). If the assets of the distributing corporation or any controlled corporation are acquired in a Type A, C, or D reorganization (or any other transaction specified in regulations), the shareholders of the acquiring corporation are treated as acquiring stock in the corporation from which the assets were received. IRC §355(e)(3)(B).

**.2 Existence of a Plan**

If one or more persons directly or indirectly acquire a 50-percent or greater interest in the distributing corporation or any controlled corporation during the four year period beginning two years before the distribution, the acquisition is presumed to be pursuant to a plan unless it is established that such a plan did not exist. IRC §355(e)(2)(B).

**.3 Exceptions and Special Rules**

**(A) Continuing Direct or Indirect Ownership**

An acquisition generally does not require gain recognition under IRC §355(e) if the same persons own more than 50 percent in the distributing or any controlled corporation directly or indirectly both before and after the acquisition, provided the stock was not acquired as part of a plan to gain such control. IRC §355(e)(3)(A)(iv).

***Example 2.1***

*Individual A owns all of the stock of P Co. which owns all of the stock of S Co. P Co. distributes its S Co. stock to A in a transaction that otherwise qualifies under IRC §355. If, as part of a plan, P Co. then merges into X Co., gain recognition is not required if A owns directly or indirectly more than 50 percent of X Co. This assumes A did not acquire stock in P as part of a plan to acquire 50 percent or more of P or S separately by A.*

**(B) Single Affiliated Group**

An acquisition does not require gain recognition under IRC §355(e) if immediately after completion of the plan the distributing corporation and all controlled corporations are members of a single affiliated group of corporations (as defined in IRC §1504 without regard to subsection (b)). IRC §355(e)(2)(C).

***Example 2.2***

*P Co. is a member of an affiliated group that includes subsidiary S Co. and subsidiary S1 Co. P owns all the stock of S and S owns all the stock of S1. P is merged into unrelated X Co. in a transaction in which former shareholders of X will own 50 percent or more of X after the merger. As part of the merger plan, S will distribute its S1 stock to X in a transaction that otherwise qualifies under IRC §355. After the distribution, X, S and S1 will remain members of a single affiliated group of corporations. Even though there has been an acquisition of P, S, and S1, and a distribution of S1 by S that is part of a plan, the plan is not treated as one that requires gain recognition on the distribution of S1 because S and S1 remain within a single affiliated group.*

**(C) Distributions in Title 11 or Similar Cases**

An acquisition does not require gain recognition under IRC §355(e) if it is made in a title 11 or similar case. IRC §355(e)(4)(B).

**(D) Other Acquisitions Not Taken Into Account**

Except as provided in regulations, the following other types of acquisitions are not taken into account unless the stock owned before the acquisition was acquired pursuant to a plan to acquire a 50-percent or greater ownership interest in either the distributing or any controlled corporation: (1) the acquisition of stock in any controlled corporation by the distributing corporation (e.g., a drop-down of property to the corporation to be distributed in exchange for stock); (2) the acquisition of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation (e.g., receipt by a distributing corporation shareholder of controlled corporation stock in a distribution—including a split-off distribution in which a shareholder that did not own 50 percent of the stock of the distributing corporation owns 50 percent or more of the stock of the controlled corporation); and (3) the acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation (e.g., the receipt by former shareholders of the distributing corporation of 50 percent or more of the stock of a successor corporation in a merger of the distributing corporation). IRC §355(e)(3)(A)(i)-(iii).

**(E) Coordination With IRC Section 355(d)**

IRC §355(e) does not apply to any distribution to which IRC §355(d) applies. IRC §355(e)(2)(D).

**(F) Statute of Limitations Extended**

The statute of limitations for assessment of a deficiency attributable to any gain recognized under IRC §355(e) is extended to three years after the IRS is notified that the distribution occurred. The deficiency may be assessed before expiration of such three-year period even if other rules would prevent the assessment. IRC §355(e)(4)(E).

**.4 Intragroup Distributions**

**(A) Introduction**

Except as provided in regulations, IRC §355 does not apply to the distribution of stock from one member of an affiliated group to another member of such group if the distribution is part of a plan described in IRC §355(e)(2)(A)(ii), pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing or any controlled corporation. IRC §355(f).

**(B) Basis Adjustments in Intragroup Transactions**

In the case of any distribution of stock of one member of an affiliated group to another member under IRC §355 (an intergroup spin-off), the Treasury is now authorized to provide adjustments to the basis of any stock in a corporation which is a member of such group to reflect appropriately the proper treatment of the distribution. IRC §358(g). The conference committee report makes clear

that this authority permits the Treasury to modify the rules under IRC §355(f), relating to intragroup spin-offs that involve an acquisition, as may be appropriate. New IRC §358(g) lets the Treasury address intragroup spin-offs designed to eliminate an excess loss account of a lower tier subsidiary or take advantage of situations where a disproportionate amount of asset basis (as compared to value) is in one of the companies.

**.5 Determining Control Immediately After Certain Distributions**

The Act modifies certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction satisfies IRC §355. In those cases, under IRC §351 and IRC §368(a)(2)(H) (relating to Type D reorganizations), shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they own stock possessing more than 50 percent of the total combine voting power and value of all stock in the distributed corporation. IRC §§351(c)(2), 368(a)(2)(H)(ii).

**2.2.6 Certain Preferred Stock Treated as "Boot"**

**.1 Introduction**

The Act defines "nonqualified preferred stock" as other property (i.e., "boot") for purposes of IRC §§351, 354, 355, 356, and 1036. IRC §§351(g), 354(a)(2)(C)(i), 355(a)(3)(D), 356(e), 1036(b). Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either IRC §§351, 355, 368 or 1036, gain but not loss will be recognized. The IRS is given regulatory authority to implement these provisions and prescribe the treatment of nonqualified preferred stock under other Code provisions. IRC §351(g)(4).

**.2 Nonqualified Preferred Stock**

**(A) In General**

Nonqualified preferred stock is generally defined as preferred stock (stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent) if (1) the holder has the right to require the issuer or a related person (under IRC §§267(b) or 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices. IRC §§351(g)(2)(A), 351(g)(3)(A), 351(g)(3)(B). Categories (1), (2), and (3) of nonqualified preferred stock apply only if the right or obligation with respect to the redemption or purchase of the stock may be exercised within the 20-year period beginning on the stock's issue date and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. IRC §351(g)(2)(B). A right or obligation to redeem or purchase preferred stock does not make it nonqualified if the right or obligation may be exercised only upon the death, disability, or mental incompetency of the holder, and the stock surrendered or received in the exchange is not in a publicly traded corporation or in another corporation and the exchange is part of a transaction or series of transactions in which the corporation is to become publicly traded. IRC §§351(g)(2)(C)(i)(I), 351(g)(2)(C)(ii). A right or obligation to redeem or purchase preferred stock



transferred as reasonable compensation in connection with the performance of services for the issuer or a related person, does not make the stock nonqualified if the right or obligation may be exercised only upon the holder's separation from service. IRC §351(g)(2)(C)(i)(II).

**(B) Conversion or Exchange Rights**

The conference report states that a conversion privilege into stock of the issuer will not automatically be considered to constitute participation in corporate growth to any significant extent. The conference report also states that stock that is convertible or exchangeable into stock of a corporation other than the issuer (e.g., a parent corporation or other related corporation) is not considered to be stock that participates in corporate growth to any significant extent.

**.3 IRC Section 351 Exchanges**

In an IRC §351 exchange, nonqualified preferred stock is treated as "boot" under IRC §351(b). IRC §351(g)(1)(C). However, the conference report states that unless and until regulations are issued such stock is treated as stock received by a transferor for purposes of qualifying the transaction under IRC §351(a).

**.4 Exchanges Under Sections 354 and 355**

Nonqualified preferred stock generally is treated as other property in exchanges governed by IRC §§354 or 355. IRC §§354(a)(2)(C)(i), 355(a)(3)(D). However, under both of those sections nonqualified preferred stock is treated as stock or securities when it is received in exchange for nonqualified preferred stock. Id. In cases where both IRC §351 and IRC §354 may apply to a transaction, the House report states that generally IRC §354 will apply.

**.5 Recapitalizations of Family-Owned Corporations**

Nonqualified preferred stock is treated as stock or securities under IRC §354 in the case of an IRC §368(a)(1)(E) recapitalization of a "family-owned corporation." IRC §354(a)(2)(C)(ii)(I). Thus, recognition of gain may be avoided when such stock is received in a qualifying exchange. A family owned corporation is defined in IRC §447(d)(2)(C) as a corporation in which at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and at least 50 percent of all other classes of stock are owned by members of the same family. To be a family-owned corporation, the corporation must satisfy this test throughout the 8-year period beginning on the date 5 years before the recapitalization. A taxpayer's family is defined as including the taxpayer, the taxpayer's brothers and sisters, the brothers and sisters of the taxpayer's parents and grandparents, and the ancestors, lineal descendants, spouses, and estates of any of the foregoing individuals. IRC §447(e)(1). Individuals related by the half blood or by legal adoption are treated as related by the whole blood and special attribution rules apply to stock owned by partnerships, trusts, and corporations. IRC §§447(e)(2), 447(e)(3).

**2.2.7 IRC Section 304 Redemptions**

Under the Act, to the extent that an IRC §304 transaction is treated as a distribution under IRC §301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which IRC §351(a) applies, and (2) the acquiring corporation had redeemed the stock it was treated as issuing in the transaction. IRC §304(a)(1). A new provision relating to acquisitions by a foreign corporation was also added to IRC §304. IRC §304(b)(5). In

addition, the Act amends IRC §1059 so that if an IRC §304 transaction is treated as a dividend to which the dividends-received deduction applies, the dividend is treated as an extraordinary dividend in which only the basis of the transferred shares is taken into account under IRC §1059. IRC §1059(e)(1)(A)(iii)(II).

## **2.2.8 Modification of Holding Period for Dividends-Received Deduction**

The Act provides that a corporate taxpayer is not entitled to a dividends-received deduction unless stock is held for over 45 days during the 90-day period beginning on the date which is 45 days before the ex-dividend date. IRC §246(c)(1)(A). In the case of stock having preference in dividends, the dividends-received deduction is available for dividends attributable to a period or periods in excess of 366 days if the stock is held for over 90 days during the 180-day period beginning on the date which is 90 days before the ex-dividend date. IRC §246(c)(2).

## **2.2.9 Modification of Investment Company Exceptions**

The Act modifies the definition of an investment company for purposes of determining whether a transfer of property to a corporation or partnership results in gain recognition under IRC §351(e) or IRC §721(b) by requiring that certain assets be taken into account for purposes of the definition, in addition to readily marketable stocks and securities. Under the Act, an investment company includes a corporation or partnership if more than 80 percent of its assets by value consists of money; stocks and other equity interests in a corporation; evidences of indebtedness, options, forward or futures contracts; notional principal contracts or derivatives; foreign currency; certain interest in precious metals; and interests in REITs, RICs, common trust funds and publicly-traded partnerships or other interests in noncorporate entities that are convertible into or exchangeable for any of the assets listed. Also counting toward the 80-percent test are an interest in an entity substantially all of the assets of which are listed, and to the extent provided in regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to assets listed. The Act also grants authority to the IRS to add other assets to the list and, in certain circumstances, remove items from the list. See IRC §351(e)(1)(B). The Senate Committee report states that the Act is intended to change only the types of assets considered in the definition of an investment company in Reg. §1.351-1(c)(1)(ii), and not to override other provisions in the regulation.

## **2.2.10 Disallowance of Deduction on Certain Corporate Debt Instruments**

### **.1 Introduction**

Under the Act, no interest deduction is allowed for any interest paid or accrued on a "disqualified debt instrument." IRC §163(l)(1).

### **.2 Disqualified Debt Instrument**

A disqualified debt instrument is any indebtedness of a corporation which is payable in equity of the issuer or a related party (as defined under IRC §267(b) or 707(b)). IRC §163(l)(2). Indebtedness is treated as payable in equity of the issuer or a related party only if a substantial amount of the principal or interest is required either (1) to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, such equity, or (2) to be determined, or at the option of the issuer or related party is determined, by reference to the value of such equity. IRC §§163(l)(3)(A), 163(l)(3)(B). Indebtedness is also treated as payable in equity if it is part of an arrangement which is reasonably expected to result in a transaction described above. IRC §163(l)(3)(C). Principal and interest is treated as required to be so paid, converted, or determined if it may be required at the option of the holder or the related person and there is a substantial certainty the option will be exercised. IRC §163(l)(3). The IRS is given

regulatory authority to prevent avoidance of this provision through use of an issuer other than a corporation. IRC §163(l)(5).

## **2.2.11 Corporate Contributions of Computer Technology or Equipment for Elementary or Secondary School Purposes**

### **.1 Introduction**

New IRC §170(e)(6) creates a new contribution that will qualify for the augmented charitable deduction under IRC §§170(e)(3). Under IRC §170(e)(6), a gift of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in any grades of K-12 qualifies for the augmented deduction. IRC §§170(e)(6)(B), 170(e)(6)(E)(i). In the case of an augmented charitable deduction the taxpayer may deduct its basis in the property plus one-half of the amount of ordinary income or short-term capital gain that would have realized if it had sold the property. However, the deduction may not exceed double the basis of the property. IRC §§170(e)(6)(A), 170(e)(3)(B).

### **.2 Statutory Requirements**

Eligible donees are: (1) any educational organization that normally has a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) IRC §501(c)(3) entities that are organized primarily for the purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee. To qualify, a contribution must be made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. The special IRC §170(e)(6) rule applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations under IRC §414(m)(3) are not eligible donors. IRC §170(e)(6)(E)(ii). IRC §170(e)(6) does not apply to any contributions made during any taxable year beginning after December 31, 1999. IRC §170(e)(6)(F).

## **2.2.12 Related Parties Under IRC Section 267**

Under IRC §267, losses from the sale or exchange of property, directly or indirectly, between certain related persons are disallowed. Under IRC §267(f), losses from the sale or exchange of property between members of the same controlled group of corporations (as defined) generally are deferred, rather than denied, until the property is transferred outside the group. New IRC §267(f)(4) provides that in the case of any other Code section which refers to a relationship which would result in a disallowance of losses under IRC §267, deferral of losses under IRC §267(f) shall be treated as disallowance. IRC §267(f)(4). Thus, such cross-references now include controlled groups of corporations covered by IRC §267(f). This provision is effective for tax years beginning after December 31, 1983.

## **2.2.13 NOL and General Business Credit Carrybacks and Carryforwards**

### **.1 Changes in NOL Carryback and Carryforward Periods**

The net operating loss (NOL) carryback period in IRC §172(b) is shortened from three years to two years and the NOL carryforward period is extended to 20 years from 15 years. The three-year carryback period is retained for (1) individuals, with respect to losses of property arising from casualties and theft, and (2) small businesses and taxpayers engaged in the trade or business of farming, with respect to net operating

losses attributable to Presidentially declared disasters. IRC §172(b)(1)(F). A "small business" generally is a corporation, partnership, or sole proprietorship with average gross receipts for the preceding three-taxable-year period of \$5 million or less. IRC §172(b)(1)(F)(iii). The new NOL carryback and carryforward periods apply to NOLs for taxable years beginning after enactment of the Act.

**.2 Changes in General Business Credit Carryback and Carryforward**

The carryback period for unused general business credits is shortened from three years to one year and the carryforward period for such credits is extended from 15 to 20 years. IRC §39(a)(1). The new credit carryback and carryforward periods apply to credits arising in taxable years beginning after December 31, 1997.

**2.2.14 Registration of Confidential Corporate Tax Shelters and Substantial Understatement Penalty**

**.1 Introduction**

A tax shelter organizer is now required under IRC §6111 to register any confidential corporate tax shelter with the IRS. IRC §6111(d). The legislative history states that a tax shelter promoter also must maintain lists of those who have signed confidentiality agreements, or otherwise been subjected to nondisclosure requirements. If the promoter is not a U.S. person, or if the registration is not made, then each U.S. person who discussed participation is required to register the shelter. IRC §6111(d)(3)(A). An exception to the special registration rule exists if the U.S. person who discussed participation notifies the promoter within 90 days that it will not participate in the shelter and the U.S. person does not in fact participate. IRC §6111(d)(3)(B). The new registration requirements apply to interests offered to potential participants after the IRS prescribes guidance under the provision.

**.2 Definition of Confidential Corporate Tax Shelter**

A corporate tax shelter is any entity, plan, arrangement, or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant (direct or indirect), (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of \$100,000. IRC §6111(d)(1). A transaction is offered under conditions of confidentiality if (1) an offeree (or a person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to limit disclosure of the tax shelter or any significant features of the tax shelter, or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim, or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or any aspect thereof) is proprietary to any person other than the offeree or is otherwise protected from disclosure or use. The promoter includes specified parties related under IRC §§267 or 707. IRC §6111(d)(2).

**.3 Penalty**

The penalty for failing to timely register a corporate tax shelter is the greater of \$10,000 or 50 percent of all fees paid to all promoters with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fees paid with respect to offerings after late registration). IRC §6707(a)(3)(A). A similar penalty applies to actual participants who were required to register the tax shelter but did not. For participants, the 50 percent penalty is based on fees paid by the participant. IRC §6707(a)(3)(B)(ii). In the case of an intentional failure to register a corporate tax shelter the 50 percent penalty is increased to 75 percent.

**.4 Changes in Substantial Underpayment Penalty**

The Act also makes changes in the IRC §6662 substantial underpayment penalty. Under the changes (1) a corporation is treated as never having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation, and (2) a tax shelter is now defined as an entity with a significant purpose (rather than principal purpose) of avoiding or evading Federal income tax. IRC §§6662(d)(2)(B), 6662(d)(2)(C).

**2.2.15 Changes in the Corporate AMT**

**.1 Repeal of AMT for Small Businesses**

The Act repeals the corporate AMT for small businesses beginning after December 31, 1997. IRC §55(e)(1). A corporation that has average annual gross receipts of less than \$5 million for a three-year period ending on or after December 31, 1996, is a small business corporation for its next taxable year. IRC §55(e)(1)(A). A corporation that meets this test continues to be exempt from the AMT so long as its average annual gross receipts for the previous three-year period do not exceed \$7.5 million. IRC §55(e)(1)(B). If a corporation ceases to be a small corporation, it generally will be subject to the AMT only with respect to preferences and adjustments that relate to transactions and investments entered into on or after the first day of the first year it is subject to the AMT. IRC §§55(e)(2)-(4). The AMT credit allowable to a small business corporation exempt from the AMT during the year is limited to the amount by which its regular tax liability (reduced by other credits) exceeds 25 percent of the excess (if any) of its regular tax liability (reduced by other credits) over \$25,000. IRC §55(e)(5).

**.2 Modification in AMT Depreciation Adjustment**

For property (including pollution control facilities) placed in service after December 31, 1998, the Act conforms the recovery periods for the AMT depreciation adjustment to the recovery periods used for regular tax purposes. IRC §§56(a)(1)(A)(i), 56(a)(5).

**2.2.16 Extension of Various Tax Credits and Creation of New Welfare-to-Work Tax Credit**

The Act generally extends the expiration of various tax credits. The research and experimentation credit is retroactively extended through June 30, 1998. IRC §41(h). The work opportunity credit is also extended to June 30, 1998. IRC §51(c)(4). The IRC §45C orphan drug credit has been made permanent. The Act also provides to employers a tax credit on the first \$20,000 of eligible wages paid to qualified long-term family assistance recipients (as defined) during the first two years of employment. The credit is 35 percent of the first \$10,000 of eligible wages in the first year of employment and 50 percent of the first \$10,000 of eligible wages in the second year of employment. IRC §51A(a). The maximum credit is \$8,500 per qualified employee. The welfare-to-work credit is effective for wages paid to a qualified individual who begins work for an employer on or after January 1, 1998, and before May 1, 1999. IRC §51A(f).

**2.2.17 Expanded Limitations on Corporate Owned Life Insurance Policies (COLI)**

**.1 Expansion of Premium Deduction Limitation**

The Act creates new limitations on deductions in connection with corporate owned life insurance policies. No deduction is allowed for premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract. IRC §264(a)(1). However, the new premium deduction limitation does not apply to premiums with respect to any annuity contract described in IRC §72(s)(5) (relating to certain qualified pension plans, certain retirement annuities,

individual retirement annuities, and qualified funding assets), nor to premiums with respect to any annuity to which IRC §72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person). IRC §264(b). Previously, a deduction for premiums was disallowed when the taxpayer was a beneficiary under a policy covering the life of any officer or employee, or any person financially interested in any trade or business carried on by the corporation. The new limitation applies to contracts issued after June 8, 1997, in taxable years ending after that date.

**.2 Expansion of Interest Disallowance Limitation**

No deduction is allowed for interest paid or incurred on any indebtedness with respect to a life insurance policy or endowment or annuity contract, covering the life of any individual. IRC §264(a)(4). Previously, such interest was not deductible if the policy or contract covered an officer or employee, or an individual financially interested in any trade or business carried on by the taxpayer. The special rule allowing a deduction for interest with respect to policies or contracts covering certain key persons is retained. IRC §264(e)(1). The new limitation applies to contracts issued after June 8, 1997, in taxable years ending after that date.

**.3 Pro Rata Disallowance of Interest on Debt to Fund Life Insurance**

Under the Act, no deduction is allowed for that portion of the taxpayer's interest expense allocable to unborrowed policy cash values (generally the cash surrender value of a policy or contract over any loan with respect to such policy or contract). IRC §§264(f)(1), 264(f)(3). Interest expense is allocable to unborrowed policy cash values in an amount which bears the same ratio to such interest as the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts issued after June 8, 1997, bears to the sum of (1) the average unborrowed policy cash values of such contracts, and (2) the average adjusted bases of all of the taxpayer's other assets. IRC §264(f)(2). Exceptions are provided for: (1) policies and contracts covering one individual who is a 20-percent owner or an officer, director or employee, and (2) policies and contracts held by a natural person. IRC §§264(f)(4), 264(f)(5). New IRC §264(f) generally applies to contracts issued after June 8, 1997, in taxable years ending after that date.

**2.2.18 Expensing of Environmental Remediation Costs**

**.1 Introduction**

New IRC §198(a) allows a taxpayer to elect to expense a "qualified environmental remediation expenditure" when such expense is paid or incurred. The election applies to expenditures made after enactment of the act and before January 1, 2001. IRC §198(h).

**.2 Qualified Environmental Remediation Expenditures**

The term "qualified environmental remediation expenditure" is defined as any expenditure which is otherwise chargeable to capital account and which is paid or incurred in connection with the abatement or control of hazardous substances (as defined under environmental law) at a qualified contaminated site. IRC §§198(b)(1), 198(d). The cost of depreciable property used in connection with the abatement or control of hazardous substances may not be expensed under IRC §198 but depreciation on such property allocable to the site is treated as a qualified environmental remediation expenditure. IRC §198(b)(2). A qualified contaminated site is one (1) held by the taxpayer for use in a trade or business or for the production of income, or which is IRC §1221(1) property in the hands of the taxpayer, (2) which is in a targeted area (as

defined), and (3) at or on which there has been a release (or threat of release) or disposal of any hazardous substance. IRC §198(c)(1)(A). An area is treated as a qualified contaminated site only if the taxpayer receives a statement from the appropriate state agency that such area meets requirements (2) and (3), above. IRC §198(c)(1)(B). Qualified environmental remediation expenditures that are expensed under IRC §198 are recaptured as ordinary income on a sale or disposition of the property. IRC §198(e).

#### **2.2.19 Modifications to Look-Back Method for Long-Term Contracts**

The Act provides that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income or loss under the contract as determined using estimated contract price and cost is within ten percent of the cumulative taxable income or loss using actual contract price and costs. The Act also provides that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the contract is completed, the cumulative taxable income or loss under the contract is within ten percent of the cumulative look-back income or loss as of the most recent year in which the look-back method was applied. IRC §460(b)(6). Finally, the Act provides that for purposes of the look-back method, only one rate of interest is to apply for each interest accrual period. IRC §460(f)(7). These new provisions apply to contracts completed in taxable years ending after enactment of the Act.

#### **2.2.20 Notices Disregarded on Large Corporate Underpayments**

The Act provides that for purposes of determining the period to which the large corporate underpayment interest rate applies, any letter or notice is disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than \$100,000 (determined by not taking into account any interest, penalties, or additions to tax). IRC §6621(c)(2)(B)(iii).

#### **2.3.0 Tax Treatment of Target's Expenses in Resisting a Hostile Takeover**

In *A.E. Staley Manufacturing Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), the Seventh Circuit reversed the Tax Court and permitted a target corporation to deduct expenses incurred in unsuccessfully resisting a hostile takeover. In the case, the taxpayer paid over \$12 million to investment bankers and for printing costs in connection with its response to hostile tender offers. In analyzing the tax treatment of those payments, the Seventh Circuit stated that the Supreme Court's *INDOPCO* decision "did not change the law with respect to costs incurred to defend a business. Such costs seek to preserve the status quo, not to produce future benefits, and are therefore deductible." The court then proceeded to analyze whether the costs incurred by the taxpayer were more properly viewed as costs associated with defending a business or as costs associated with facilitating a capital transaction. The court concluded that the bulk of the taxpayer's costs related to its defense of its business and corporate policy and were deductible under IRC §162(a). Costs properly allocable to unsuccessful efforts to engage in an alternative transaction that would prevent the acquisition (e.g., a financial restructuring, a recapitalization, a sale of equity, or a joint venture) were also deductible under IRC §165. However, fees paid to evaluate the taxpayer's stock and the few hours of work to facilitate the eventual merger were required to be capitalized. The Seventh Circuit remanded the case to the Tax Court to allocate a sum of the fees for capitalization.

#### **2.4.0 Annual Retainer Paid to Law Firm Deductible by Corporate Taxpayer**

In *Dana Corp. v. United States*, 97-2 U.S.T.C. ¶50,566 (Fed. Cl. 1997), the Court of Federal Claims held that a \$100,000 annual retainer paid to a law firm was an ordinary and necessary

business expense deductible under IRC §162. The retainer was paid to a firm regarded as an expert in the field of corporate takeovers and made to ensure that Dana Corp. could use the firm's services and its competitors could not. The retainer agreement permitted Dana Corp. to also employ the firm for matters unrelated to takeovers. In any year when Dana Corp. did not use the firm's services, the firm kept the entire retainer. During several years the law firm performed no services and kept the entire retainer. In the year at issue, Dana Corp. acquired another corporation and incurred \$265,000 of legal fees. The law firm credited the \$100,000 retainer fee and Dana paid \$165,000, which it capitalized. The court held that the origin of the \$100,000 payment occurred in January when it was paid and not when it was applied to the legal services rendered in the acquisition.

## **2.5.0 Proposed Regulations Issued on Continuity of Shareholder Interest in Corporate Reorganizations**

### **2.5.1 Introduction**

Proposed regulations provide that the continuity-of-shareholder interest requirement in an acquisitive corporate reorganization is satisfied if the acquiring corporation furnishes consideration in the reorganization that represents a proprietary interest in the affairs of the acquiring corporation and such consideration represents a substantial part of the value of the stock or properties transferred. Prop. Reg. §1.368-1(e)(1).

### **2.5.2 Post-Acquisition Continuity**

Under the proposed regulations, dispositions of stock of the acquiring corporation by a former target shareholder generally are not taken into account in determining whether continuity of shareholder interest has been satisfied. Prop. Reg. §1.368-1(e)(3) Example 1. However, the proposed regulations state that all facts and circumstances must be considered in determining whether the acquiring corporation has in substance furnished the required consideration. If the acquiring corporation or a related party (under IRC §707(b)(1) or IRC §267(b), without regard to IRC §267(e)) redeems or acquires acquiring corporation stock shortly after the reorganization, all facts and circumstances must be considered in determining whether continuity of shareholder interest is satisfied. Prop. Reg. §1.368-1(e)(1). The proposed regulations apply with respect to the stock of the corporation in control of the acquiring corporation in a forward triangular merger or in control of the merged corporation in a reverse triangular merger. Prop. Reg. §1.368-1(e)(2). The new proposed continuity-of-shareholder-interest rules apply to transactions occurring after final regulations are published, except that they do not apply to any transactions occurring pursuant to a written agreement which is binding prior to the time final regulations are published. Prop. Reg. §1.368-1(e)(4).

## **2.6.0 Proposed Regulations Issued on Remote Continuity of Interest and Continuity of Business Enterprise**

### **2.6.1 Remote Continuity of Interest**

Proposed regulations provide that in an acquisitive reorganization (Type A, B, C or G (meeting the requirements of IRC §354(b)(1)(A) and (B))) continuity of interest is satisfied where there are transfers of assets or stock to members of a qualified group. Prop. Reg. §1.368-1(f)(1)(i). A qualified group is one or more chains of corporations connected through stock ownership with the "issuing corporation", but only if the issuing corporation has control (under IRC §368(c)) of at least one other corporation, and stock meeting the requirements of IRC §368(c) in each of the other corporations is owned directly by one of the other corporations. Prop. Reg. §1.368-1(d)(5)(iii). The proposed regulations also provide that continuity of interest is satisfied where a



target's assets are transferred to a partnership in exchange for a partnership interest. Prop. Reg. §368-1(f)(1)(ii). However, stock of a target may not be transferred to a partnership where the Code imposes a control requirement under IRC §368.

## **2.6.2 Continuity of Business Enterprise**

Proposed regulations also provide that continuity of business enterprise is not violated in an acquisitive reorganization (Type A, B, C, or G (meeting the requirements of IRC §354(b)(1)(A) and (B))) by the fact that all or part of a target's assets or stock are transferred among members of a qualified group (as defined above). Prop. Reg. §1.368-1(d)(5)(ii). Continuity of business enterprise is also satisfied when all or part of the target's assets are transferred to a partnership by a corporate partner following the acquisition if the corporate partner has active and substantial management functions as a partner with regard to the business or if the corporate partner's interest in the partnership represents a significant interest in the partnership business. Prop. Reg. §1.368-1(d)(5)(v)(A). The corporate partner is also treated as owning a proportionate interest in the partnership's assets and conducting a business of the partnership under the rules applicable to business continuity. Prop. Reg. §1.368-1(d)(5)(v)(B). The new proposed continuity-of-business-enterprise regulations apply to transactions occurring after final regulations are published, except that they do not apply to any transactions occurring pursuant to a written agreement which is binding prior to the time final regulations are published. Prop. Reg. §1.368-1(d)(5)(vi).

## **2.7.0 Proposed Regulations Issued on Receipt of Rights to Acquire Stock of a Corporation That is a Party to the Reorganization**

Proposed regulations provide that for purposes of IRC §§354, 355, and 356, rights to acquire stock issued by a corporation that is a party to a reorganization are treated as securities of the corporation. Prop. Reg. §§1.354-1(e), 1.355-1(c), 1.356-3(b). The proposed regulations treat rights to acquire stock as securities having no principal amount. Thus, a taxpayer will not be required to recognize any gain under IRC §356 upon receipt of a stock right, regardless of whether the taxpayer surrenders stock, stock rights, or debt securities. *Id.* Note that the proposed rules apply only for purposes of determining the amount of gain recognized in a reorganization exchange in a transaction qualifying under IRC §§368 or 355. The proposed rules do not address whether the transaction qualifies under those provisions.

## **2.8.0 Proposed Regulations Issued on Certain Asset Transfers to a Tax-Exempt Entity**

### **2.8.1 Introduction**

Proposed regulations under IRC §337 provide that if a taxable corporation transfers all or substantially all of its assets to one or more tax-exempt entities, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market value. Prop. Reg. §1.337(d)-4(a)(1). Various exceptions apply to the recognition rule, including one for a transfer of assets to a tax exempt entity if the assets are used in an activity subject to tax under IRC §511 as unrelated business taxable income. Prop. Reg. §1.337(d)-4(b)(1). A taxable corporation's change to a tax-exempt entity is generally treated as a transfer by the corporation of all of its assets to a tax-exempt entity. Prop. Reg. §1.337(d)-4(a)(2).

### **2.8.2 Special Rules**

The proposed regulations contain exceptions for changes in status of the following corporations: (1) a corporation previously tax-exempt that regains its tax-exempt status within three years from the later of a final adverse adjudication on its status or filing a return as a taxable corporation, (2) a newly formed corporation that is tax-exempt within three taxable years after the taxable year it is formed, or (3) a corporation previously tax-exempt or that applied but did not receive tax-exempt status before January 15, 1997, if it is tax-exempt within three years from when the regulations are final. Prop. Reg. §1.337(d)-4(a)(3)(i). An anti-abuse rule also applies to a corporation that, with a principal purpose of avoiding the regulations, acquires all or substantially all of the assets of another taxable corporation and then changes its status to that of a tax-exempt entity. Prop. Reg. §1.337(d)-4(a)(3)(iii). A loss limitation rule applies if (1) assets are acquired by a taxable corporation under IRC §351 or as a contribution to capital, or (2) assets are distributed to a shareholder or member of the taxpayer's affiliated group, with a principal purpose of having the taxable corporation recognize loss on the transfer of its assets to the tax-exempt entity. Prop. Reg. §1.337(d)-4(d). The new proposed regulations apply to transfers of assets after 30 days following publication of final regulations, unless the transfer is pursuant to a written agreement binding on or before that date. Prop. Reg. §1.337(d)-4(e).

## **2.9.0 Amendments to Temporary Regulations Under IRC Sections 1060 and 338(b) Relating to Purchase Price Allocations in Taxable Asset Acquisitions and Deemed Asset Purchases**

Temporary and final regulations under IRC §§1060 and 338(b) were amended to place all IRC §197 intangibles other than goodwill and going concern value in class IV. Reg. §§1.1060-1T(d)(2)(iv), 1.338(b)-2T(b)(iv). Thus, goodwill and going concern value are assigned to a true residual class V.

## **2.10.0 Final Regulations on IRC Section 1059 Extraordinary Dividends**

Final regulations under IRC §1059(e) (treatment of partial liquidations and non-pro-rata redemptions as extraordinary dividends) were issued. Under the final regulations, IRC §1059(d)(6) (exception where stock held during entire existence of corporation) and IRC §1059(e)(2) (qualifying dividends) do not apply to any distribution treated as an extraordinary dividend under IRC §1059(e)(1). Reg. §1.1059(e)-1(a). Also, any reorganization exchange under IRC §356 is treated as a redemption and, to the extent any amount is treated as a dividend under IRC §356(a)(2), it is treated as a dividend under IRC §301 and an extraordinary dividend. Reg. §1.1059(e)-1(b). The new regulations apply to distributions announced on or after July 17, 1996. Reg. §1.1059(e)-1(c).

## **2.11.0 IRS Issues New Guidance on Advance Pricing Agreements**

Revenue Procedure 96-53, 1996-49 I.R.B. 9, informs taxpayers how to secure an advance pricing agreement from the Office of the Associate Chief Counsel (International) covering the prospective determination and application of transfer pricing methodologies under IRC §482 for international transactions.

## **2.12.0 Final Regulations Issued for IRC Section 338 Consistency Rules With Respect to Target Affiliates That Are Controlled Foreign Corporations**

Final regulations were issued relating to the consistency rules under IRC §338 that are applicable cases involving controlled foreign corporations. See Reg. §1.338-4(h).

### **2.13.0 Dividends Paid to ESOP Not Deductible in Computing ACE**

In *Snap-Drape Inc. v. Commissioner*, 98 F.3d 194 (5th Cir. 1996), the Fifth Circuit concluded that the taxpayer was not entitled to deduct dividends paid to an ESOP in computing adjusted current earnings for purposes of the alternative minimum tax. The court held that Reg. §1.56(g)-1(d)(3)(iii)(E), which denies such a deduction, is valid and could be applied retroactively. In *Schuler Industries, Inc. v. United States*, 109 F.3d 753 (Fed Cir. 1997), the Court of Appeals for the Federal Circuit also held that the same regulation is valid and denied the taxpayer a deduction in computing ACE for dividends paid to an ESOP.

### **2.14.0 Circuit Court Upholds AMT Book Income Regulation**

In *CSX Corp. v. United States*, F.3d (4th Cir. 1997), the taxpayer sought a refund of approximately \$4.8 million of AMT. The refund related to the treatment of three items in calculating the taxpayer's book income adjustment for 1987. The first item related to a \$954 million restructuring charge taken for financial accounting purposes by CSX in 1985. For tax purposes, CSX accrued approximately \$110 million of the charge in 1987. The second item was the 1987 portion of an accounting error made by a subsidiary which was recognized in 1988. The third item was a reduction in the book income adjustment related to an accounting change by a subsidiary.

The IRS rejected CSX's claim for refund based on Reg. §1.56-1(d)(4) which does not permit a corporation to adjust book income to reflect timing differences. See Reg. §1.56-1(d)(4)(viii) Example (1). The District Court ruled in favor of CSX concluding that because the regulation does not permit adjustments for "omissions", it violates former IRC §56(f)(2)(l). The Seventh Circuit reversed the District Court decision and upheld the regulation. The court said the fundamental problem with CSX's position was that it sought to apply a deduction from taxable income to book income. The court also said the regulation is supported by the plain language of the Code, the statute's legislative history, and the purpose of the AMT.

### **2.15.0 Oil Producer's Lifting or Production Costs Excluded from Adjusted Ordinary Income for PHC Tax Purposes**

In *Rhoades Oil Co. v. United States*, 116 F.3d 489, 97-2 U.S.T.C. ¶150,506 (10th Cir., 1997), the Tenth Circuit held in an unpublished opinion that an oil producer's lifting or production costs are properly excluded from gross income in calculating adjusted ordinary gross income for personal holding company purposes.